

Office of Chief Counsel
Internal Revenue Service
memorandum


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LNPrimavera

OCT 8 1998

date:

to: Revenue Agent Mike Birecree
Group 1107, Southern California, Laguna Niguel POD

from: Lisa Primavera, Attorney 
June Y. Bass, Assistant District Counsel
District Counsel, Southern California, Laguna Niguel

subject: Request for Legal Opinion


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DISCUSSION

We write in response to your oral request for advice in the above-referenced case.

You asked whether the loss realized on the worthlessness of section 197 assets, which were written off prior to the time they were fully amortized, must be disallowed and allocated to the basis of a covenant not to compete acquired in the same transaction. Additionally, you asked whether, if the first question is answered in the affirmative, the reallocated basis must be amortized over the remaining portion of the 15-year period prescribed in section 197, even though the contractual term of the covenant not to compete was less than 15 years.

CONCLUSION

The loss on the worthlessness of the section 197 intangibles is disallowed and must be reallocated to any remaining section 197 intangibles acquired in the same or series of related transactions.

Further, to the extent that the loss is allocated to the covenant not to compete, the basis must continue to be amortized over the remaining 15-year period.

However, we suggest that further factual development be undertaken to determine whether any section 197 intangibles, other than the covenant not to compete, were retained. We also caution that, to the extent that all of the interests acquired from [REDACTED] became worthless or were disposed of, the covenant not to compete may also be considered worthless. Further development of this area is also warranted.

FACTS

The taxpayer acquired substantially all the assets of [REDACTED] from [REDACTED] in [REDACTED].¹ The assets consisted primarily of technical manuals, patents, copyrights and similar assets. The acquisition was made as part of the acquisition of the trade or business of [REDACTED]. In connection with the asset acquisition, the taxpayer negotiated a covenant not to compete with [REDACTED]. The covenant bound [REDACTED] not to compete for a period of [REDACTED] years.

In [REDACTED], the taxpayer determined that the intangible assets acquired from [REDACTED] (the technical manuals, etc.) were worthless. The taxpayer wrote off the remaining basis of those assets. The taxpayer claimed the loss on its tax return.

ANALYSIS

I.R.C. § 197(a) provides that section 197 intangibles shall be amortized ratably over a 15 year period. Section 197 is the exclusive authority for amortizing such intangibles. I.R.C. § 197(b). Section 197 intangibles are any section 197 intangible acquired after the effective date of the statute and which is held in connection with the conduct of a trade or business or an activity described in section 212.

Section 197(d) defines those assets which constitute section 197 intangibles. Such assets include:

- business books and records, operating systems, or any other information base (including lists or other

¹ We assume for purposes of this memorandum that the acquisition was made after the August 10, 1993 effective date of section 197, added by the Revenue Reconciliation Act of 1993, P.L. 103-66 or that the taxpayer made a valid election to apply that section to the transaction.

information with respect to current or prospective customers). I.R.C. § 197 (d)(1)(C)(ii);

- any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item. I.R.C. § 197(d)(1)(C)(iii); and

- any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof. I.R.C. § 197(d)(1)(E).

Section 197(f)(1)(A) provides that if any amortizable section 197 intangible acquired in a transaction or series of related transactions is disposed of becomes worthless and one or more other amortizable section 197 intangibles acquired in such transaction or series of related transactions are retained, then no loss shall be recognized by reason of the disposition or worthlessness, and appropriate adjustments to the adjusted bases of such retained intangibles shall be made for any loss not recognized.

It is clear that the technical manuals, patents, copyrights and similar assets acquired by the taxpayer from [REDACTED] as well as the covenant not to compete constitute section 197 intangibles. They are required to be amortized over 15 years regardless of the actual economic useful lives of the assets.

The loss realized on account of the worthlessness of the section 197 intangibles is not recognized. Instead, the appropriate adjustment to the remaining section 197 intangibles acquired in connection with the [REDACTED] transaction must be made. The remaining section 197 intangibles, including the covenant not to compete, are still subject to the 15 year amortization. See Prop. Treas. Reg. § 1.197-2(g)(1)(iii).

However, Prop. Treas. Reg. § 1.197-2(g)(1)(iii) also suggests that a covenant not to compete may be considered worthless when all of the interests in the acquired trade or business become worthless or are disposed of. We do not have enough information to determine whether all of the interests in the [REDACTED] trade or business became worthless or were disposed of in [REDACTED]. Also, we do not know whether there are any remaining section 197 intangibles, other than the covenant not to compete, to which the basis could be allocated. Because this information is necessary for a complete analysis, we suggest that you make further inquiries.

If you have any questions or require our further assistance, please phone attorney Lisa Primavera at (949) 360-2689.